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# ASPECTS OF THE INCOME TAX

BY SYDNEY BROOKS

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FEW events during the past decade have impressed foreign students of American affairs with such a sense of real importance as the recent adoption of the income-tax amendment to the Constitution. Both from the political and the economic standpoint it has been hailed in Europe as a decisive development. Changing the American Constitution is an enterprise so beset with difficulties and delays that it had almost come to be regarded abroad as impossible. Since the beginning of the nineteenth century Americans have altered their fundamental law five times only. The first time was in 1804 when an amendment was ratified clearing up certain ambiguities in the method of choosing the President and the Vice-President. The next three occasions occurred in the sixties when the Thirteenth, Fourteenth, and Fifteenth amendments, registering the results of the Civil War, were added to the Constitution without either the assent or participation of the seceding Southern States. Then came an interval of over forty years during which the Constitution remained absolutely unchanged—a singular testimony either to the foresight of its framers, or its lack of adaptability to modern conditions, or to the innate conservatism of the American people. In the course of those four decades it was no doubt modified from time to time in spirit, if not in form, by judicial interpretation and the slow and subtle growth of custom. But it was never formally amended. In the past hundred and ten years the American Constitution had thus been altered once in a purely technical detail that involved no question of principle, and three times as the consequence of a terrible convulsion. The adoption of the income-tax amendment on February 3d may, therefore, be said to be the only instance in well

over a century in which the Constitution of the United States has been amended in any matter of genuine moment, under normal circumstances, and in accordance with the methods laid down by its framers. I need hardly add that this flickering of flexibility in an instrument so long looked upon as fossilized is welcomed in Europe as an auspicious sign that even in America things move and the dead hand is not omnipotent.

But on economic as well as political grounds the friends of America abroad regard the ratification of the income-tax amendment as a substantial step in the right direction. When the Constitution laid it down that no capitation or other direct tax should be imposed except by apportioning its incidence among the several States on the basis of their population, it raised the most effective barrier to any rational system of taxation that could possibly have been devised, and it practically forced the United States Government to depend for its revenue upon customs duties. Legal ingenuity, however, can get round anything; and the Supreme Court decided as long ago as 1789 that an income tax was not a direct tax and need not therefore be apportioned among the States. During the Civil War, by three successive Acts of Congress, taxes were actually levied on incomes and their constitutional validity was upheld by the Supreme Court. The worst of legal ingenuity, however, is that it cannot be depended on. In 1895 the Supreme Court reversed its decision of fifteen years earlier and incidentally shattered the fiscal programme of the Democratic party by pronouncing the income tax to be a direct tax, and therefore incapable of being levied except in strict proportion to the population of the various States, and therefore, in effect, incapable of being levied at all. There has been no more conspicuous instance in our time of the dangers of allowing a Court from which there is no appeal to determine the validity of a legislative enactment. The consequences of the decision of 1895 were to deny to the United States Government the right to tax incomes or personal property from whatever source and of whatever kind, to restrict it still further to indirect taxes as virtually its sole source of revenue, to deprive it of a power that might one day be vital to the safety of the Union, and to exhibit it in a condition of feebleness that was altogether incompatible with any sound conception of a sovereign State. All these disabilities

have now been removed, and the Democrats must surely feel that with the adoption of the income-tax amendment, a great obstacle has been cleared from their path. To-day, as twenty years ago, the crucial task that confronts them is the downward revision of the tariff. It can only be effectively accomplished if they possess and can exercise the power to offset the almost inevitable decline in revenue by the imposition of direct taxation. The ratification of the amendment gives them this power and I assume they will not be slow to use it. Just as the proceeds of the income tax enormously facilitated Great Britain's conversion to Free Trade so it seems likely that the Democrats will utilize the same source of revenue to balance their inroads upon the schedules of the Payne Tariff Act. It is true, as I understand the matter, that they will be embarrassed by some difficulties that did not affect the British statesmen of the 'forties, and particularly by the dual sovereignty that permeates the American form of government. One of the essential principles, apparently, of the American Constitution is that the Federal Government cannot tax the agencies and instrumentalities of a State Government, nor a State Government tax the agencies and instrumentalities of the Federal Government. Congress, in other words, in spite of the adoption of the income-tax amendment, cannot, if I am rightly informed, tax incomes derived from investments in State or Municipal bonds, any more than a State could levy on the salary of a Federal officeholder; and I apprehend that it may prove a matter of considerable difficulty and delay to draw the exact line between the taxing prerogatives enjoyed by the two authorities. But the great thing, after all, is that the Federal Government should at last be in a position to adopt what is perhaps, or what can at any rate be made, as equitable a system of taxation as any that has yet been framed.

The justice and expediency of a tax on incomes have so long been admitted by all the leading nations of Europe that the theoretical arguments for it and against it have almost ceased to be discussed. The principle of an income tax is all but universally accepted throughout the Old World; it is only its application and its results that now concern economists. One would scarcely anywhere in Europe find a journal of position arguing, for instance, as more than one New York periodical has argued within the last few

weeks, that taxes levied on income derived from industry are inequitable and oppressive, and disputing the old maxim that the burden of taxation should be distributed so as to bear most heavily on those best able to sustain it. But it may, perhaps, be useful, before taking up specific instances of the income tax in practice, to enumerate in general terms its advantages and disadvantages. It is claimed for it, then, that on the whole it is the fairest of all taxes; that a citizen's obligation to support the Government that protects him cannot be discharged more equitably than by making him contribute a certain portion of his net income; that the incidence of the tax automatically adjusts itself to the ups and downs of each individual's financial position; that it is the simplest thing in the world to graduate it so that it bears more hardly proportionately upon the rich than the poor; that it embraces persons and classes who would otherwise escape all direct taxation and thus stimulates a general interest in the efficiency and economical working of government; that its imposition, unlike most indirect taxes which are very largely taxes on consumption, does nothing to disturb prices; and that, while admittedly difficult to collect, it is eminently productive and places in the statesman's hands a potent instrument, if not of social justice, at least of social retribution. As against this, however, it is contended that to tax incomes is really to tax enterprise, industry, and energy, and to relieve the shiftless and the indolent, to mulct the honest and to let the dishonest escape scot-free; that the method of collecting it must to some extent be necessarily inquisitorial; that the ease with which the tax can be dodged invites to perjury and evasion—Gladstone, when he was meditating its total repeal, declared that it made a nation of liars; that it is essentially a piece of class legislation inasmuch as it presses very heavily on a few, less heavily on more, comparatively lightly on a still larger number, and not at all on the great bulk of the population; and finally, that it tends to drive capital abroad.

It is not difficult to bring these statements to the test of fact by reference to the case of Great Britain. The income tax was introduced into Great Britain by William Pitt in 1799 under the stress of the French war. It was abolished in 1816, when Waterloo had put an end to the pecuniary pressure, but Sir Robert Peel revived it in 1842 and Gladstone considerably extended it in 1853. From being a tempo-

rary war tax it has now become a permanent part of the British financial system, and is resorted to by every Chancellor of the Exchequer who finds himself in difficulties. Pretty nearly every one who has resided in Great Britain for more than a year on end is brought within its scope. Whatever his nationality the odds are that he will find himself placed under Schedule D of the income-tax assessment, bombarded with official documents that have to be filled up and returned to the local surveyor of taxes within seven days, and threatened with a host of penalties if he assaults the collector or makes "an untrue return." Schedule D casts a wide net. It does not matter whether you are a British subject or not, whether you live in the United Kingdom or outside of it, whether your "trade, profession, employment, or vocation" is carried on in England or abroad. Your income may come from the United States and you yourself be an American citizen, but if you live in England Schedule D will get you. Or you may be a Frenchman living in France, but if your income is derived from any form of business carried on in Great Britain, Schedule D will still circumvent you. All that you can do is to take the fullest advantage of the various abatements and deductions that are permitted or else to juggle frankly with your conscience. Most Englishmen do both. It is only the immaculate minority that declares its full income. The average man confronted with the income-tax papers takes a modest, a depreciatory, even a pessimistic view of his profits and of the extent to which he feels justified in disclosing them. None the less Mr. Gladstone's dictum that the income tax had made a nation of liars stands in need of certain deductions that have no small weight with such a being as man in such a world as the present. In the first place, it is not considered a grave offense against morality to put one's income, for the purpose of tax assessment, at somewhat below its proper figure. It is like the smuggling of the returned American tourist, a sporting compromise with one's conscience that does not necessarily argue bad citizenship or an abnormal degree of immorality. There are a few people whose better self regains the upper hand when they quietly contemplate their crime and who make restitution to the Treasury. You frequently see in the London papers an acknowledgment from the Chancellor of the Exchequer of the receipt of such and such a sum from such and such

a person, whose initials but not whose name are given, as "conscience money." But the mass of Englishmen wear their guilt in the matter like a flower, lightly and even jubilantly. And in the second place it must be remembered that the opportunities for a serious underestimate are not very great. There is one, not indeed infallible but tolerably accurate, test of a man's income—the house he lives in and the rent he pays for it. These two items are matters of public record and if a statement of income appeared to be in flagrant conflict with them, a hint from the local Surveyor of Taxes or a demand for the production of account-books would in most cases be enough to bring the two sets of figures into a more appropriate harmony. On the whole, therefore, I should not say that the exercises in mental and moral prestidigitation that accompany the filling up of the income-tax returns do any vital harm to the national character. From that standpoint Americans, I think, might risk it. After conniving for forty years at the monstrous frauds of the pension roll, and with their transcendent skill in ending the tax on personal property wherever it is imposed, my conviction is that they are amply barricaded against the contaminating influences of an income tax.

There is another point on which British experience is illuminating—I mean the alleged inquisitorial character of the tax. Once every year the British Government, taking stock of all the resources that may be drawn upon to build Dreadnoughts against Germany, to float a scheme of national insurance, to grant Home Rule to Ireland, and what not, lights upon my insignificant self and still more insignificant income as an asset that should be turned to account. It is the only occasion on which, as an average British subject, I am brought into direct contact with the national taxing authorities; and, frankly, I do not find that our annual momentary connection bears much resemblance to an inquisition. I am supplied by mail with the necessary papers; I fill them up and return them to the designated official; and there, nine years out of ten, the matter ends. I do not recall more than one or two instances in which I have been asked to explain how I arrived at a certain figure or in which I have felt impelled to protest against the assessment. The normal thing is for the Commissioners to accept my calculations and for me to accept theirs, and for the transaction to be concluded with a check for the amount

due from me. I am by no means any more eager than my neighbors to pay taxes in any form and unquestionably there are times when a man of moderate income, like myself, finds that it involves a real inconvenience to meet this particular impost. But as a rational being one recognizes that the Government must have money and one is altogether at a loss to say in what way the wealth derived from property and investments can be so adequately, so regularly, and so equitably laid under contribution. An income tax is unpopular just as every other direct tax is unpopular, but mingling with and mitigating its unpopularity is the sense that on the whole it is a just tax. What, however—to return to the point I was dealing with—helps most of all to take the edge off popular resentment is that about three-fourths of the amount collected is not assessed directly on the ultimate payers, but at the source of origin. I own stock, let us say, in a railroad company. The income tax is assessed on and collected from the railroad company in one sum and the burden of it distributed among the stockholders in proportion to their holdings. My dividends, that is, reach me “less income tax.” In this way evasion is made extremely difficult, the productivity of the tax is largely increased, and its incidence is deprived of that personal element and of that immediate contact between the individual and the tax-collecting agency which are largely responsible for the unpopularity of imposts. It is, in short, quite vital to remember, when considering the inquisitorial character of the income tax, that the great bulk of its proceeds are gathered indirectly, not from the taxpayer but from the companies in which he has invested his savings.

Moreover, one must bear in mind that a wise statesmanship is never unduly stringent in its methods of enforcing the payment of taxes. There are many kinds of income to which the system of assessment at the source cannot be applied at all, or can only be applied very imperfectly; as, for instance, the profits derived from a private business, the income derived from a profession, and certain descriptions of income derived from abroad. In these cases the British Government has to rely largely on self-assessment by the taxpayer, and it is here that scope is found for fraud and evasion. Either there is a deliberate under-statement of the profits in the return; or no return is sent in at all, either with the hope of escaping notice altogether or with



the hope that, if an official assessment is made, it will be less than the real profit. "The evidence goes to show," reported a Parliamentary Committee that sat on the question some six or seven years ago, "that many people, who shrink from making a false statement, can yet reconcile it with their consciences to defraud their neighbors by mere passive neglect of their obligations." And besides all this there is also much avoidance of the tax due to ignorance, carelessness, or inability to understand and correctly fill up the forms. In this way there is no doubt a considerable annual loss to the revenue; but the authorities are for the most part content to put up with the loss rather than incur the unpopularity of adopting a rigorous procedure. The penalty for not making a return or for making an incorrect return is a fine not exceeding one hundred dollars and treble the duty properly chargeable. This is at once too slight a punishment for wilful evasion and too heavy a one for carelessness or ignorance. It is true that the Commissioners can, and often do, put pressure on the defaulters by making or raising an assessment whenever they have *prima facie* evidence that there is unsatisfied liability. But very often evidence is lacking; and the method of making a high assessment in the dark, as a means of compelling disclosure, is not altogether satisfactory and would be still more unsatisfactory if it were to be established as a general rule. Those, too, the whole of whose income is already taxed at the source, rarely take the trouble to make any return at all. It was estimated seven years ago that about a third of the forms sent out are put in the waste-paper basket; and the difficulty of discovering the cases of deliberate evasion is thus enormously increased. All these sources of leakage could be stopped. It might be made obligatory on every individual to fill up the forms under penalty of a small fine; the punishment for making incorrect returns might be increased; frauds might be publicly exposed; the revenue authorities might be given greater powers for levying a surcharge or supplementary assessment in cases of proved evasion; the whole machinery for detecting fraud might be improved. But Governments in a matter of this kind cannot advance an inch beyond public opinion; they are doubtful, as they well might be, whether "the man in the street" would support an energetic administration of an inevitably unpopular law; and they pre-

fer, and I think very wisely prefer, to err on the side of mercy, to tolerate abuses rather than wage open war on them, to develop at the same time the efficiency of their system so that misdemeanors may be headed off one by one and without any overt scandal, and to avoid anything that would stir up the public mind against the tax itself.

The income tax at present levied in Great Britain stands at 1s 2d in the pound, or a fraction over five per cent. The sources of income on which the tax is levied are divided into five schedules. Schedule A includes income derived from the ownership of lands and houses; Schedule B from the occupation of lands; Schedule C from British, Indian, Colonial and Foreign Government securities; Schedule D from business concerns, private employments, professions, and investments in railways and industrial enterprises; and Schedule E from the salaries of Government, municipal, and company officials. Of these schedules the fourth—Schedule D—is by far the most important, being responsible for well over half the gross amount of revenue brought under review. It is the Schedule which most closely concerns the average man who is not a landowner or a house-owner, or a public official and who has little money invested in Government securities but who carries on a business or profession, receives a salary, and puts his savings into railway and industrial companies. Let us see how he stands under it. First of all, if his income from all sources does not exceed \$800 per annum he pays no tax at all. If it is between \$800 and \$2,000 he is entitled to an abatement of \$800; if between \$2,000 and \$2,500 to an abatement of \$750; if between \$2,500 and \$3,000 to an abatement of \$600; and if between \$3,000 and \$3,500 to an abatement of \$350. Furthermore if his total income is less than \$10,000 a year he pays only ninepence in the pound (about three and one-half cents in the dollar) on that portion of it which is earned income; and if it is between \$10,000 and \$15,000 a year he pays only one shilling in the pound (five cents in the dollar) on that portion of it which is earned. The full rate of one shilling and two pence in the pound (all but six cents in the dollar) only begins to apply when the income exceeds \$15,000 per annum. But when the income exceeds \$25,000 a year a supertax of twelve cents is levied on every five dollars of income over and above \$15,000. The features in the British system that are most worthy of note by Ameri-

cans at the present juncture are therefore (1) the total exemption of small incomes; (2) the abatements allowed on moderate incomes; (3) the distinction drawn between earned and unearned income; (4) the progressive and graduated character of the tax; and (5) the supertax on the large incomes.

The first thing that an Englishman has to do when grappling with Schedule D is to calculate his "income," and for this purpose he must remember that his wife's income is deemed to be his own. The way in which he is directed to proceed with his calculations is simple and fairly equitable. He begins by striking an average of the profits of the three past years arising from his "trade, profession, employment, or vocation." From this he is entitled to make deductions (1) for the repairs of premises occupied for the purpose of trade and manufacture and for the supply or repair of implements, articles, or utensils employed; (2) for debts proved to be bad and for doubtful debts at their estimated value; (3) for the rent of premises that are used solely as a place of business; (4) for two-thirds of the rent of any dwelling-house which is partly used for the purposes of business; (5) for wear and tear of machinery and plant; (6) for life-insurance premiums paid on the claimant's own life or on that of his wife, so long as the amount so paid does not exceed one-sixth of the net income from all sources; (7) for a reduction of £10 on account of each child of under sixteen if the total income is less than \$2,500 a year; and (8) for "any other disbursements or expenses wholly and exclusively laid out for the purposes of the trade, etc." On the other hand, no deductions are allowed for any interest on capital, or for sums paid as salaries to partners, or for sums invested or employed as capital in the trade or business, or for sums expended on improving the premises or written off for depreciation of land, buildings, or leases, or for any loss not connected with or arising out of the trade, or recoverable under an insurance or contract of indemnity, or for any sum expended on domestic and private purposes. It will thus be seen that in Great Britain the income tax might much more fairly and intelligibly be described as a tax on profits and on profits ascertained by a three years' average, and that in ascertaining this figure there are substantial deductions to be made. If, for instance, you are a doctor and receive patients at home, you

may deduct two-thirds of the rent of your house, the whole of the rent of an outside office, the salaries of your assistants and locum-tenens, the cost of drugs, medical books, and instruments, and, I should say—though the Commissioners might dispute it—the keep or hire of your brougham or motor-car.

A few more words may be added to bring out various aspects and details of the British system. Thus it is interesting to note that the assessment of the tax on real estate is based on rental or rentable value, with deductions allowed for repairs, improvements, and other outlays of one-sixth on houses and buildings and one-eighth on land. The tax is collected from the tenant of the property, whether occupier or owner. I am myself, for instance, the tenant of the house in which I live and simultaneously with the income tax I am yearly levied on for a Property Tax and an Inhabited House Duty. The latter comes out of my own pocket; but the former I am entitled, after paying it, to deduct from the next quarter's rent due to the landlord. So far as government and municipal securities are concerned the procedure is equally simple, the bankers or agents being compelled to deduct the income tax before issuing the dividend warrants. Very much the same method applies also to railroads and industrial corporations carrying on business within the United Kingdom, except that the income-tax assessment is levied on the full profits of the undertaking, after a reasonable allowance for managerial expenses and depreciation, but irrespective of the amounts actually declared and distributed in the form of dividends. As it must frequently happen that the dividends from which the income tax has thus been deducted go to persons whose total income exempts them from all payment of the tax, the Inland Revenue authorities are constantly obliged to refund the moneys they have collected—to the extent of some \$15,000,000 a year; and the business of advising and prosecuting such claims against the Treasury has grown into quite an extensive branch of commercial enterprise. One occasionally hears in Great Britain of economists advocating an almost universal income tax, to be levied on all wage-earners in receipt of over six or seven dollars a week and to be deducted from the pay-roll by the employer. But though undoubtedly something might be said for such a suggestion, it is quite obviously not within the sphere

of practical politics; and speaking generally, there is no decided movement of opinion in favor either of lowering or increasing the present limit of exemption which stands at \$800 a year. The super-tax on incomes of over \$25,000 is much more closely representative of the present trend of democratic politics, and in Great Britain, where it is a comparative novelty, it already produces over \$15,000,000 a year. It cannot, however, be indefinitely extended except at the risk, which even now is an apparent risk, of driving capital abroad. This is not altogether the disastrous development it appears to be, because the more British capital is invested abroad, the better on the whole for the industrial prosperity and expansion of the kingdom. But from the standpoint of the Treasury it is open to the objection that an Englishman who invests his surplus in a foreign country, and allows his bankers or agents in that country to reinvest his dividends for him, escapes altogether the operation of the income tax. This is a tendency which the super-tax on big incomes seems likely to emphasize. It is, at any rate, rather too soon to be quite certain that a high rate of assessment on the millionaire may not defeat its own object by inducing him to remove his capital beyond British jurisdiction. For the rest, it is worth noting that of the \$220,000,000 now raised by the income tax some \$50,000,000 comes from incomes derived from the ownership of lands and houses, about \$15,000,000 from home and foreign Government securities, and some \$130,000,000 from business, professions, and ordinary investments; and that each penny of the tax brings into the Treasury nearly \$15,000,000.

I have no means of knowing whether the American Democrats who clearly intend to try their hands at framing an income-tax law have studied the complexities of the subject, or have grounded themselves in the various problems of abatement, exemption, and graduation, or cherish the hope of wiping all such problems out of existence by simply levying a bold percentage on all incomes of over \$5,000 a year. But whatever they decide to do they will probably find that one or other of the countries of Europe has been before them. There are as many theories and practices, one might almost say, in regard to the income tax as there are nations. In the German and Swiss confederations the income tax while levied by the separate States, forms part of the national sources of revenue. In Prussia it affects the whole in-

come of the taxpayer; elsewhere it is designed either to supplement existing taxes or to fall only on certain forms of income which otherwise would go free; in Austria it is a personal tax superimposed on six other taxes; in Bavaria it leaves untouched incomes already reached by other taxes on, for instance, land and industry; while in Spain and Italy it affects personalty only. The diversity in regard to the methods of graduation is equally great. In the German group, speaking broadly, the taxpayers are arranged in a number of categories, usually well over one hundred, according to the amount of income returned by or ascribed to them, and a definite sum of money is fixed as the tax in each category. In other States the categories are few in number and each one of them is taxed at a certain percentage rate which rises proportionately within the category and progressively at a few specified points; while in others the scale of progression is based upon, or combined with, the partial exemption of income from taxation. Practically all the States of Europe adopt some limit of exemption, but in every case it is lower than the British limit. In Saxo-Altenburg, for instance, it stands at \$15, in Switzerland it varies in different cantons from \$20 to \$240; in Prussia it is \$225 and in Saxony \$100. Exemptions of a special character also obtain—municipal and charitable institutions, for instance, naval and military men, domestic servants, heads of families with children to support, or even, as in the canton of Fribourg, “ agriculturists, printers, engravers, sculptors, and midwives ”; and abatements are also allowed for continuous illness, debts, or special misfortune. Prussia with a rate of .67 per cent. on \$225 rising to 4 per cent. on \$25,000; Saxony with a rate of .25 per cent. on \$100 rising to 5 per cent. on \$25,000 and over; Austria with a rate of .6 per cent. on \$260 rising to 4 per cent. on \$20,000; Sweden with a rate of .2 per cent. on \$275 and a maximum of 4 per cent. on \$40,000; and Denmark with a minimum rate of 1.3 per cent. on \$195 and a maximum of 2½ per cent. on \$27,500 and over—may all be quoted as examples that depart widely from the British system. If one were to go deeper into the matter and to note the innumerable ways in which the income tax is differentiated—in which, that is to say, a different rate is levied on different kinds of income—and in which “ unearned ” income is taxed at a higher rate than “ earned ” income, this article, without touching at all on

the intricacies of assessment and collection, would be well on the way to becoming a volume. Enough, however, has already been said to show the complexity and the fascination of the task on which the Democrats are now free to embark and the urgent need, if European experience goes for anything, of their approaching it with circumspection and a clear idea of what it exactly is that they want to achieve.

SYDNEY BROOKS.